Empire Ideas

A reform toolbox for citizens and government leaders

Number 1

Shrinking the retiree health care iceberg

THE PROBLEM:

Retiree health benefits for state and local government employees are a huge, unfunded and rapidly growing liability for taxpayers throughout New York. The rising cost of these benefits is adding to the stress on local budgets already squeezed by the economic downturn and skyrocketing public pension bills. Current costs are just the tip of a larger fiscal iceberg. New York's state, county and municipal governments and school districts have promised $250 billion worth of future retiree health coverage that no money is set aside to pay for.

THE SOLUTION:

Elected officials should use the information disclosed under new government accounting rules to help taxpayers and employees understand that their retiree healthcare promises are simply unsustainable in the long run.

To tackle the short-term, the state, its local governments and school districts should aim to:

1. Preserve existing benefits for already Medicare-eligible retirees, but end the reimbursement of Medicare Part B premiums.
2. Increase premiums paid by younger retirees, especially in localities where retirees currently pay little or nothing for their coverage.
3. Reserve the greatest tax-funded premium support for those who have worked the longest.

To reduce and eventually eliminate unfunded liabilities in the long run, governments should encourage the creation of non-governmental, employee-run Retiree Medical Trusts — an innovative funding model that can preserve retiree health coverage at no risk to taxpayers.

Defining the problem

News coverage of state and local finances tends to focus on annual budgets, but local budget documents can be both superficial and misleading. They typically understate both the current costs and long-term obligations associated with employment compensation, which is the largest component of county, municipal and school expenditures. Having a "balanced" budget in a given year does not mean a government is fiscally sound in the long run.

For a more comprehensive view of a government's financial condition, private credit analysts and potential investors in municipal bonds ignore budgets and turn to the information in annual financial reports and bond offering statements. Subject to uniform standards, these documents don't simply list annual revenues and expenditures. They also include balance sheets tallying the value of assets (such as property, equipment, and accounts receivable) and liabilities (such as accounts payable and outstanding debt). Accompanying the tables are narrative "notes" explaining the numbers. Because these reports also serve as disclosure documents, subject to federal anti-fraud statutes, they are held to a fairly high standard of accuracy.

The main elements of public sector financial reports are effectively mandated by an independent rule-making body, the Government Accounting Standards Board (GASB), which determines the Generally Accepted Accounting Principles (GAAP) used in financial statements by state and local governments.

The current method of funding retiree health benefits for public employees is really a form of borrowing. Today's employees are promised a valuable benefit, for which tomorrow's taxpayers must foot the bill.

What's in a liability?

New York State and its local governments pay for retiree health insurance coverage – in accounting terms, Other Post-Employment Benefits, or OPEB -- out of their annual budgets, a practice also known as "pay-as-you-go." This method of funding OPEB benefits, like all financial arrangements that shift current costs into the future, can also be viewed as a form of borrowing. Today's employees earn a valuable benefit, while tomorrow's taxpayers are left to foot the bill. But until recently, there wasn't even an honest accounting of what that bill will be.

That changed in 2004, when the oversight body issued a new accounting rule commonly known as GASB 45. The rule stems from the principle that retiree benefits are a form of deferred compensation whose costs should be recorded when earned, not when paid. Since 2009, GASB 45 has applied to all localities and school districts that produce GAAP-based financial statements. This includes the vast majority of counties, municipalities and school districts in New York.

The rule requires government entities to:

- Calculate the present value of all retirement health benefits that have been promised to and earned by current employees and retirees. The resulting number is called the "actuarially accrued liability," or AAL.
- If any funds have been put aside to support the health plan's future benefit payment, deduct the value of any fund assets from the AAL to produce a second figure, the "unfunded actuarially approved liability," or UAAL.
- Determine the "annual required contribution," or ARC, which combines the UAAL with the present value of health benefits earned during the past year, including the pay-as-you-go amount. Employers can spread (or "amortize") the UAAL amount over 30 years. The ARC typically is three times as large as the existing annual payment for retiree health coverage.

Finding your locality's retiree health costs

The total value of retiree health insurance promised by a local government or school district must be revealed in its Comprehensive Annual Financial Report, also known as the CAFR, which is a public document. If not posted on the Internet, the CAFR can be obtained from the government's chief financial officer – typically the treasurer, comptroller or, in the case of school districts, the business manager. Search the report for the terms "OPEB" and "GASB 45" to find notes to the financial statement detailing the size of the problem.

If the government has done any borrowing since the issuance of its latest CAFR, a more up-to-date OPEB liability estimate may be included in "Official Statements" that must accompany any bond issue. Copies of these statements, and of any updated financial disclosures, can be download at the Electronic Municipal Market Access website:

http://emma.msrb.org/Search/Search.aspx

Type the name of the local government in the green "Muni Search" box on the upper right side of the webpage, and scroll through results to find the latest bond issue. It may be necessary to refine the search, especially when the locality name or its variant (e.g., "Jefferson County") is found in many states across the country. Look for the bond issue with the latest "Dated Date." The bond issue will typically have a title such as "General Obligations Bonds Series B," or "Public Improvement Refunding Serial Bonds." Click on the title, and then click on the "Official Statement" tab to download.

As in the CAFR, information on the long-term cost of retiree health care will be found in notes to the financial statements by searching for the terms "OPEB" or "GASB 45."

GASB 45 does not actually require governments to make their "required" OPEB payments. But a locality that ignores the issue will experience a rapid deterioration in its balance sheet as its liability continues to grow – which will ultimately lead to credit rating downgrades and higher borrowing costs.

In other words, doing nothing is simply not an option. Costs to local taxpayers will grow in the absence of concerted action to reduce OPEB outlays.

Initial estimates of the retiree healthcare price-tag are reflected in Table 1 page 4, which shows the unfunded liabilities for the state government and its largest counties, public authorities and municipalities.

Unfunded Liabilities (UAAL) for Retiree Health Benefits

		UAAL $000	Households	Per Household
New York State		$73,181,000	7,317,755	$10,000
New York City		$83,900,000	3,109,784	$26,979
Largest State Public Authorities		$19,092,170		
Most Populous Counties Outside New York City				
	Region	UAAL $000	Households	Per Household
Albany County	Capital	533,884	126,251	4,229
Dutchess County	Mid-Hudson	293,500	107,965	2,718
Erie County	Western	934,228	383,164	2,438
Monroe County	Western	629,654	300,422	2,096
Nassau County	Long Island	4,618,696	448,528	10,297
Onondaga County	Central	837,800	187,686	4,464
Orange County	Mid-Hudson	451,661	125,925	3,587
Rockland County	Mid-Hudson	665,369	99,242	6,705
Suffolk County	Long Island	4,414,160	499,922	8,830
Westchester County	Mid-Hudson	2,354,330	347,232	6,780
		$ 15,733,282	3,323,116	$5,172
Most Populous Cities Outside New York City (Municipal Only)				
	County	UAAL $000	Households	Per Household
Albany	Albany	270,264	41,157	6,567
Buffalo	Erie	1,637,159	112,536	14,548
Mount Vernon	Westchester	98,540	26,260	3,752
New Rochelle	Westchester	189,690	27,953	6,786
Rochester	Monroe	564,241	87,027	6,484
Schenectady	Schenectady	191,522	26,633	7,191
Syracuse	Onondaga	911,000	57,355	15,884
Utica	Oneida	57,458	24,905	2,307
White Plains	Westchester	254,920	22,910	11,127
Yonkers	Westchester	697,300	74,550	9,353
		$ 4,872,094	593,879	$ 9,308
Most Populous Towns				
	County	UAAL $000	Households	Per Household
Amherst	Erie	145,069	48,894	2,967
Babylon	Suffolk	119,897	70,894	1,691
Brookhaven	Suffolk	281,400	162,884	1,728
Hempstead	Nassau	679,236	246,456	2,756
Huntington	Suffolk	190,444	69,311	2,748
Islip	Suffolk	204,981	103,631	1,978
North Hempstead	Nassau	133,271	227,058	519
Oyster Bay	Nassau	328,057	302,564	1,039
Ramapo	Rockland	121,749	115,885	761
Smithtown	Suffolk	153,400	121,817	1,099
		$ 2,357,504	1,643,943	$1,780
Selected Large Villages				
	County	UAAL $000	Households	Per Household
Garden City	Nassau	92,989	7,366	12,624
Harrison*	Westchester	188,219	8,375	22,474
Hempstead	Nassau	130,268	15,234	8,551
Lynbrook	Nassau	27,867	7,513	3,709
Mineola	Nassau	33,900	7,396	4,584
Ossining	Westchester	64,400	8,344	7,718
Port Chester	Westchester	53,920	9,240	5,835
Rockville Centre	Nassau	66,403	9,258	7,172
Spring Valley	Rockland	47,247	8,755	5,397
Valley Stream	Nassau	45,311	12,189	3,717
		$ 750,524	99,088	$8,269
All others, including school districts		$49,897,316		
	GRAND TOTAL	$249,783,890		

Source: Empire Center for New York State Policy

OPEB differs from pensions in several crucial respects. While pensions are pre-funded by employer and employee contributions to statewide investment trust funds, most localities fund retiree health coverage directly out of their current budgets. In most places, government retirees who have reached the minimum pension vesting period of 10 years are allowed remain in their former employers' health plan, with little or no added premium payments by those receiving the benefit.

While public pension benefits are shaped by state law, retiree health coverage is determined by each employer -- at the local level. And retiree health coverage is not covered by the state Constitution's restriction on changes to pensions benefits. Unlike pensions, OPEB can be altered, even for current retirees.

How to get a grip on local OPEB costs

First, ***answer some basic questions about the retiree health benefit plan***. Who qualifies, and how much coverage do they receive? Do benefits differ for different bargaining units and employee groups? Do retirees remain in the same plan as active employees? Do they pay the same premiums as active employees? How does post-employment coverage interact with federal Medicare benefits for retirees over the age of 65?

Second, ***determine the legal status of the retiree benefits***. In school districts and in other government entities where retiree health coverage is required by a collective bargaining agreement, any proposed changes must be a subject of union contract negotiations. But if the benefits were authorized in a local law, the local governing board can seek to unilaterally change the benefit plan.

Third, ***measure the financial impact of the benefits***, including both the current "pay-as you-go" cost of health insurance for retirees and the long-term unfunded liability for benefits promised in the future. The best source of such information is often the actuarial consultant's report that is the basis for the GASB 45 liability estimates presented in government financial statements (see "Finding your locality's retiree health costs" on page 3).

It's crucial to answer some basic questions about the structure of local retiree health plans, determine the legal status of the benefits provided, and measure the financial impact of each component of coverage.

To help identify savings opportunities, elected officials should determine the cost of each major component of their retiree health plan. For example, many public-sector OPEB plans in New York reimburse Medicare Part B premiums. As of 2012, the premium was set at $99.90 a month -- a relatively small amount for an individual, but a significant cost when spread across an entire group of former employees. By eliminating any reimbursement of Medicare Part B premiums, a local government can save up to $120,000 a year for every 100 retirees over 65.

What next?

GASB 45 nudges governments towards emulating the long-established method of financing public pensions: create off-budget trust funds invested in a diverse portfolio of financial assets, whose earnings would supplement taxpayer funding.

However, according to the state comptroller's office, New York State law does not authorize the kind of government trust funds encouraged by GASB 45 – and even if it did, they would merely replicate the biggest problem with the existing public pension system, which leaves taxpayers to shoulder all the financial risks associated with an implicit guarantee of the benefits. In the vast majority of cases, the required annual contribution to such funds would still be two to three times as much as current OPEB pay-as-you-go expenses.

There is a better way to deal with this issue. The short-term goal should be reduce the current retiree health insurance outlays that are putting pressure on the budget over the next few years. Here are three ways to do it:

1. Preserve existing benefits for already Medicare-eligible retirees, but end the reimbursement of Medicare Part B premiums.
2. Increase premiums paid by younger retirees, especially in localities where retirees currently pay little or nothing for their coverage. (For example, localities participating in the New York State Health Insurance Program are legally permitted to ask enrollees to pay up to 50 percent of individual coverage and 65 percent for dependents – far higher than now required of many public retirees.)
3. Reserve the greatest tax-funded premium support for those who have worked the longest.

Beyond such changes, the long-term goal of a local OPEB reform plan should be to abolish pay-as-you-go coverage of retirees alongside active employees, and to take taxpayers off the financial hook for long-term retiree health promises.

Employee trusts: a non-governmental alternative

Local governments ***can*** preserve health coverage for their retirees while ultimately eliminating their long-term OPEB liability — by encouraging the formation of Retiree Medical Trust (RMTs), run by and for their employees.

RMTs are similar to the Voluntary Employee Beneficiary Associations, or VEBAs, set up to provide retiree benefits to many unionized workers in the private sector. Although RMTs for state and local government employees are still rare in most of the country, they have been increasingly popular in California, Washington and Oregon, especially among police and firefighters. An important distinction: the desirable vehicle is an RMT run by and for employees – not one of the legally authorized GASB 45 trusts that could be sponsored by the government itself, which would expose to taxpayers to a continuing obligations and financial risks.

How Retiree Medical Trusts Could Work in New York

- Each RMT would be controlled and administered by its own board of trustees, which could consist solely of employee representatives. The trust would legally be a separate entity from a local government and its unions. To gain economies of scale, multi-employer trusts could be organized on a regional or countywide basis. For example, a single regional trust fund could be organized to cover the roughly 3,600 police and firefighters in Westchester County.

- Employers or employees – or both – would make negotiated fixed-dollar contributions on behalf of active workers to the RMT, which would deposit the money in investment pools managed by advisers chosen by the trustees. Like a defined-benefit pension fund, the trust would ensure regular benefit payments to retirees to cover medical costs or health insurance premiums.

- Unlike pensions, RMT benefit levels would not be guaranteed to qualified retirees. The level of benefit payments to beneficiaries could vary depending on fund performance. For that reason, RMT trustees would have a strong incentive to use conservative assumptions about investment returns and to ensure that contributions are adequate in order to pay the promised benefit.

- Employee contributions to the trust would come out of pre-tax income, and neither earnings nor the benefit payments made by RMT would be subject to federal income tax. Health benefits covered by the trust would not be counted as a GASB 45 liability.

- To qualify for favorable tax treatment under the federal Internal Revenue Code, all members of a given bargaining unit or employee class would have to participate in the same trust at the same contribution level.

- A trust fund could administer a plan with different contribution levels and different benefits, as long as all members in the same tier of each bargaining unit contribute the same amount. For example, in the case of the hypothetical Westchester County RMT cited above, the city of White Plains and its firefighters union might have agreed on a $180 monthly contribution for all members hired after a certain date, while the town of Yorktown and its police officers may have negotiated a $250 monthly contribution for newly hired officers only.

Shana Saichek, a lawyer with offices in San Diego, Ca., and Washington, D.C., who pioneered the development of the RMT concept, has worked with actuarial consultants to develop a funding model based on $50 "service unit" contribution levels and "unit multipliers" derived from actuarial assumptions.

One example, featured in an information bulletin issued by the newly created Peace Officers Research Association of California (PORAC) Retiree Medical Trust, features a 25-year employee whose union has agreed to a shared contribution level of $100 a month. After the employee's first seven years on the job, the contribution rises to $200 a month. It is estimated that this would provide a retiree health benefit estimated at $691.44 a month. The calculations assume retirement at age 55 and a relatively conservative 6.5 percent return on assets for the trust fund. The benefit level would vary depending on contribution level, career longevity and assumed rates of return on fund assets, but the example shows how an RMT can provide a significant level of post-retirement health insurance premium support for employees.

Local governments ***cannot*** create an employee-run RMT – only unions or other employee groups can do that. But government officials can do their utmost to strongly encourage the development of this approach.

In a place where the benefit is authorized solely by local law, elected officials could approach their unions with stark choice: create an RMT or risk losing access entirely to health coverage for future retirees.

Among school districts and other government employers required to collectively bargain any proposed change in retiree health benefits, the governing body could pass a resolution formally establishing a preference for RMTs as a negotiating objective.

While any switch to an RMT-based system will involve transitional costs and issues, it can clearly be a win-win solution for all concerned. For employees, such trust funds represent a way to preserve benefits that will otherwise be threatened by the continuing financial stress on governments. For employers, the trust offers a way to predictable and affordable funding that eliminates long-term liabilities.

The bottom line

Elected officials who feel their hands are now tied by collective bargaining agreements need to seize on the opportunity created by GASB 45 to acquaint their taxpayers and employees with the hard fact that these promises are simply unsustainable in the long run. In the short term, budgets already stressed by the economic downturn will be squeezed harder by rising pension bills as well as health insurance costs over the next few years. Something has got to give on this front—and soon.

— by E.J. McMahon, *Senior Fellow*

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